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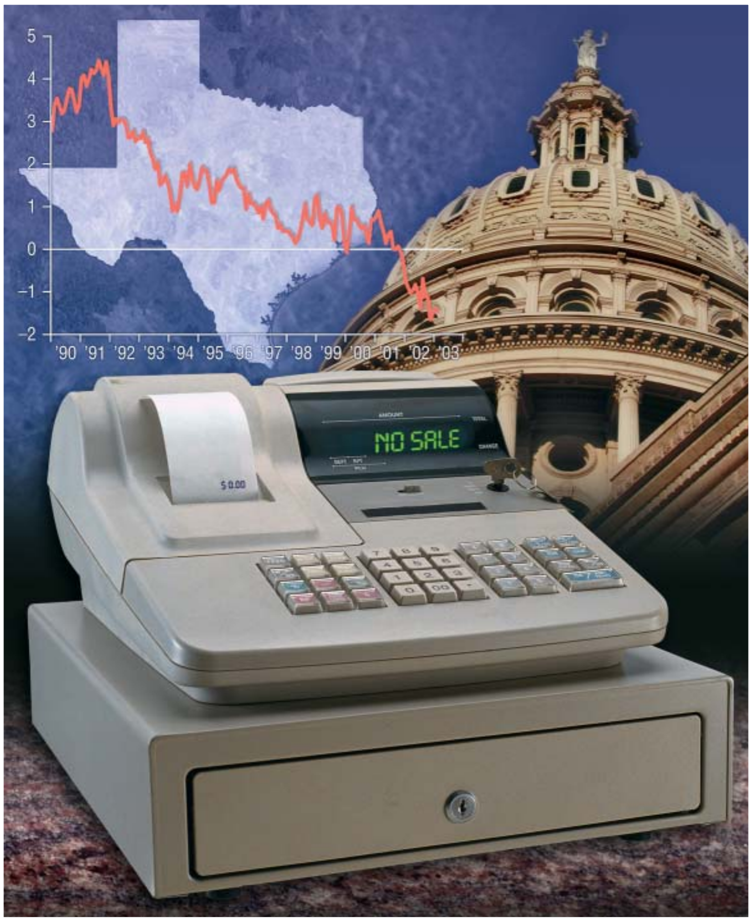
Southwest Economy



The Sales Tax Crunch

Like many others in these turbulent economic times, the state of Texas is short on cash. Changing economic conditions have forced the comptroller to revise downward her revenue estimate for the 2003 fiscal year, which ends August 31, 2003. Where the state once expected to raise $29.5 billion in general revenue funds, it now expects to raise only $27.9 billion.

The revenue shortfall is largely attributable to an unanticipated decline in revenues from the sales tax and its economic twin, the motor vehicle sales tax (*Chart 1*). Over the 2002–03 budget cycle, sales tax receipts are running more than $1.8 billion (6 percent) below original expectations; tax receipts on motor vehicle sales are running almost $0.3 billion (5 percent) below expectations. Between them, these two taxes account for more than $1.5 billion of the state's $1.66 billion revenue shortfall for 2003.

Where Texas once anticipated a 5 percent increase in tax revenue from sales and motor vehicle sales between 2002 and 2003, it now projects a 1 percent decrease. Furthermore, even the revised forecast is proving a tad optimistic. Through the first half of fiscal year 2003, revenues are down 3 percent year-over-year.

(Continued on page 2)

New Economy Myths and Reality

In the late 1990s, some economists announced that the American economy had fundamentally changed. According to this "New Economy" view, technological advances had brought on a higher sustained level of productivity growth, which allowed faster economic growth with less inflation. But given events since 2000—the long, steep stock market downturn, the falloff in business investment and the subsequent recession—many question whether anything in the New Economy view is valid.

Although those who hold this view consider accelerated productivity growth fundamental to the late '90s boom, other forces were also at work. These include the earlier deregulation of key U.S. industries, financial inno-

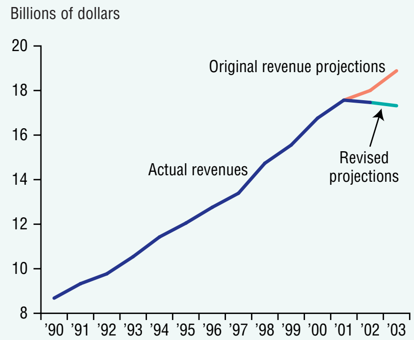
(Continued on page 5)

Texas receives more than 70 percent of general fund revenues from general and selective sales taxes.

Chart 1

Sales Tax Revenues Well Short of Projections

Sales and Motor Vehicle Sales



SOURCE: Texas state comptroller.

A number of factors could underlie the shortfall in sales tax receipts. Some of them are clearly transitory. However, others represent long-run trends that are likely to persist well into any economic recovery. Therefore, a closer examination of the sales tax decline can give insight into the prospects for continued fiscal distress in Texas.

Misery Loves Company

Texas is not alone in facing a sales tax revenue shortfall. Revenues have slowed nationwide (*Chart 2*). Nationally, sales tax revenue growth has dropped more than a percentage point since the recession started in the spring of 2001.

Slowing sales tax revenues are typical of recessions. During the 1990–91 recession, the sales tax revenues of state and local governments dropped precipitously before bouncing back. However, this time around the slowdown has been remarkably persistent. Two years after the start of the 1990–91 recession, cumulative sales tax revenues were only 1.3 percent below trend. Today, cumulative sales tax revenues are 2.6 percent below trend. (In each case, the trend presumes tax receipts had continued to grow at the same rate as in the five years prior to the recession.) In other words, despite solid consumer sales during this recession, sales tax revenues have taken twice the hit they did during the 1990–91 recession.

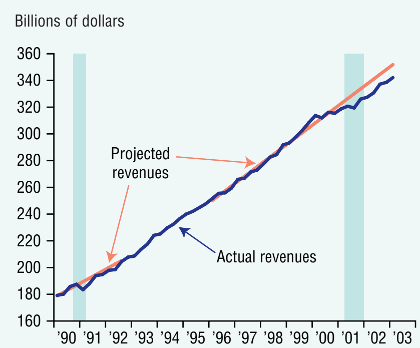
Texas has been hit especially hard by the sales tax slump. Not only are revenues falling in Texas rather than merely growing more slowly, but also Texas is much more dependent on sales taxes than the average state. Only Nevada gets a larger share of its tax revenues from sales taxes, and only three states—Nevada, Florida and Washington—get a larger share of general revenues from sales taxes.[1] As Chart 3 illustrates, Texas receives more than 70 percent of general fund revenues from general and selective sales taxes (such as taxes on the sale of motor vehicles, motor fuels, tobacco and alcoholic beverages, and insurance premiums). The lottery and other nontax revenues provide 15 percent of general revenue-related funds. The corporate franchise tax raises 7 percent of general revenues, and taxes on oil and gas extraction raise 3 percent. Severance taxes (taxes on oil and gas extraction) raise less revenue than sin taxes (sales taxes on tobacco and alcoholic beverages).

On the other hand, by relying so heavily on sales taxes, Texas has avoided the greater fiscal distress experienced in states that rely heavily on income taxes. Nationwide, state and local government revenues from the individual income tax have fallen 7 percent since peaking in the fourth quarter of 2000. More problematic, cumulative revenues from the individual income tax are 19 percent below the level a trend-based forecaster

Chart 2

Nationally, Sales Tax Shortfall More Persistent than After Last Recession

State and Local Sales Tax Revenues

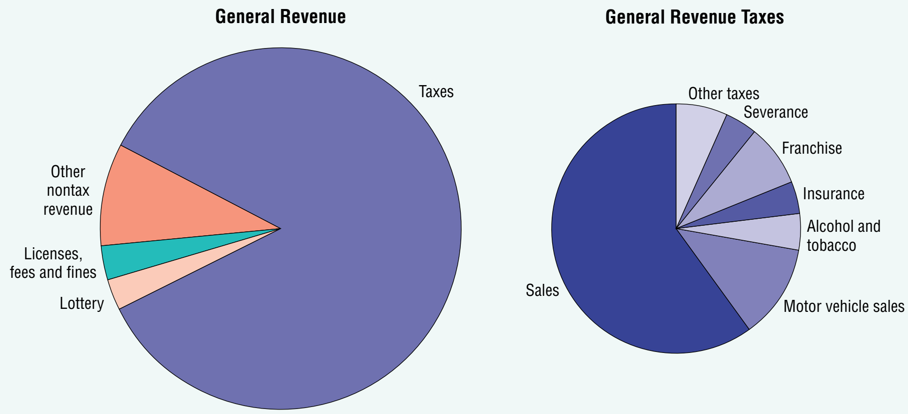


NOTES: Projections assume that receipts continued to grow at the same rate as experienced in the five years prior to the recession. The shaded areas represent national recessions.

SOURCES: National Income and Product Accounts; author's calculations.

Chart 3

Texas General Revenue, Fiscal Year 2002

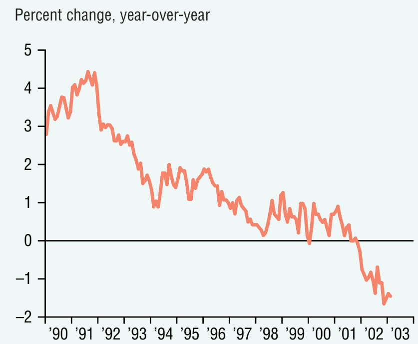


SOURCE: Texas state comptroller.

Chart 4

Goods Prices Have Been Falling

Commodities Less Food and Energy



SOURCE: Bureau of Labor Statistics.

would have projected at the start of the recession. (For a discussion of the factors behind the income tax declines, see the box titled "The Income Tax Crunch.")

Possible Explanations

A number of factors could explain the slowdown in sales tax revenues. First, personal income growth slowed during the recession. Low interest rates and mortgage refinancing have kept consumers from cutting back spending as they did during the 1990–91 recession, but growth in real consumption spending has dropped nationally by about a percentage point.

Second, consumers aren't the only ones who pay sales taxes. Taxes on business purchases account for one-third to one-half of the total revenue from sales taxes. The slump in sales tax revenue could reflect well-documented weakness in the business sector.

Third, falling prices for goods may have contributed to the slowdown in sales tax revenues. While consumer prices in general continued to rise, the price increases were driven largely by services. Prices for most consumer goods have been falling (*Chart 4*). Taxable sales tend to be of goods rather than services.

Fourth, a shift in buying habits could drag down sales tax revenues. With mortgage rates the lowest in a generation, many consumers are buying houses rather than taxable items like cars and clothes. Furthermore, consumers spend more on services (which, as noted above, are generally tax-exempt) than they do on goods (which are generally subject to sales taxes), and the services share is rising. Sales tax revenues are lost when consumers treat themselves to a week at the spa rather than a diamond ring.

Finally, consumers could be avoiding sales tax on their purchases altogether. During 2001 and 2002, sales tax revenues nationwide were $16 billion lower than expected, given the prior rate of growth. One estimate puts the tax revenue lost to increased Internet sales during 2001 and 2002 at $14 billion.[2] If this estimate is in the ballpark, then much of the sales tax revenue shortfall could be attributed to rising Internet sales.

Implications for Texas

The drop in sales tax revenues is a symptom of a general economic slump in Texas. The state's unemployment rate has risen 2.5 percentage points since the

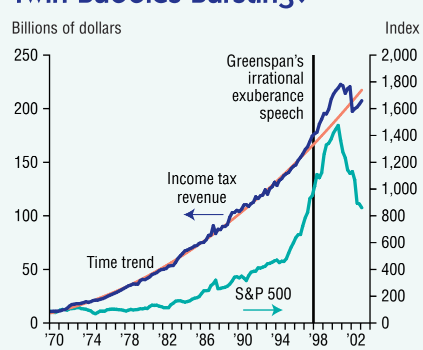
The Income Tax Crunch

State and local government revenues from the individual income tax have fallen sharply since the national recession began. The dramatic decline has at least three causes. The economic downturn is clearly part of the explanation. Personal income growth slowed markedly during the recession. Lower income growth easily translates into lower tax revenue growth.

Another contributor is the popping of the stock market bubble. All that irrational exuberance generated a lot of income tax revenue for states. Based on cumulative deviations from trend, the states received at least a $50 billion income tax windfall between 1997 and 2001 (see chart). Shortly after the stock market bubble burst, so did the tax revenue bubble.

Finally, changes in the federal income tax code took a modest toll on state and local income tax revenues. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the standard deduction, changed rules for individual retirement accounts and introduced an above-the-line deduction for higher-education expenses. The National Conference of State Legislatures estimates that EGTRRA reduced state tax revenues by at least $1.5 billion.

Twin Bubbles Bursting?



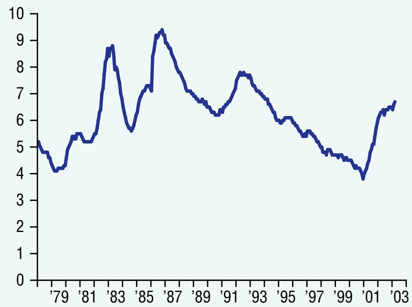
NOTE: Income tax revenue is state and local government revenue from the individual income tax.

SOURCES: National Income and Product Accounts; author's calculations.

Chart 5

Texas Unemployment Rate Up Sharply

Percent



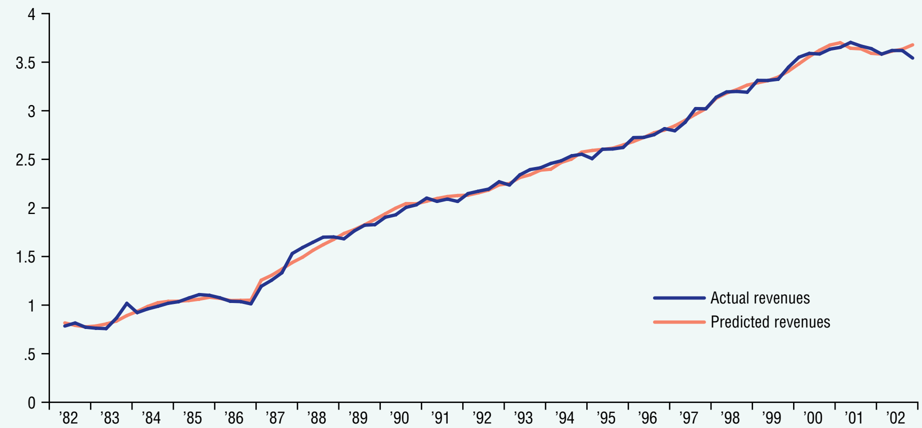
SOURCE: Texas Workforce Commission.

Chart 7

Economic Fundamentals Largely Explain Revenue Decline

Texas Sales Tax Revenues

Billions of dollars



NOTE: The analysis presented here uses sales tax data for 1982–2000 to estimate the relationship between the log of tax receipts and the log of real personal income, the log of the implicit personal income deflator, the unemployment rate and a nonlinear time trend.

start of the national recession (*Chart 5*). Employment has fallen by 126,000. Texas real personal income, which was growing at a 4 percent annual rate when the national recession began, has slowed to an average annual growth rate of less than 1 percent (*Chart 6*). Only a handful of states have seen a comparable slowdown in economic activity. Most economists attribute the slump to the national recession, weakness in the high-tech sector (on net, Texas has lost more than 100,000 high-tech jobs since March 2001), and travel and tourism declines following September 11, 2001.

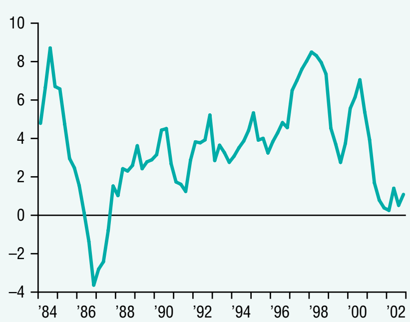
Chart 7 compares actual sales tax receipts with the level that would have been expected, given the historical relationship between tax receipts, the unemployment rate, real personal income and prices. Most of the slowdown in Texas sales tax revenues can be attributed to the weak economy. Historical patterns imply sales tax revenues for the first five quarters of the 2002–03 biennium of \$18.1 billion; in actuality, they were \$18 billion.[3]

Because economic fundamentals can explain so much of the revenue slump, there is little left to be explained by other factors. Consumers are clearly spending an increasing share of their income on services and doing an increasing share of their buying online, but such behaviors have yet to have a significant impact on Texas' tax revenues. There is no evidence that the slowdown in revenues is caused by leakage from the tax system.

Chart 6

Texas Personal Income Growth Slowest Since the Bust

Percent change (1996 dollars)*



* Year-over-year.

SOURCE: Bureau of Economic Analysis.

Conclusions

Like many other states, Texas is in a revenue squeeze. A decline in sales tax revenues has cut more than \$1.5 billion from the current fiscal year budget. However, the loss in revenues is largely attributable to an unusually weak economy. As the economy recovers, revenue growth is also likely to recover.

It would take a powerful economic rebound, however, to put the state back on its prior fiscal trajectory. Had revenues from the sales tax and the motor vehicle sales tax continued to grow at the 6 percent annual rate experienced during the 2000–01 biennium, Texas would have \$8 billion more revenue during the 2004–05 biennium than the comptroller now projects. To reach that level, taxable sales would need to grow by more than 27 percent over the next two years (13 percent per year). Few forecasters anticipate such a surge in purchasing. Therefore, the recession's impact on the Texas budget is likely to persist far longer than the recession itself.

—Lori L. Taylor

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Notes

1. These estimates come from the Census Bureau's 2000 Survey of Governments. The sales tax category includes both general sales taxes and selective sales taxes.
2. Author's calculations from "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates" by Donald Bruce and William F. Fox, Center for Business and Economic Research, University of Tennessee, September 2001, and "E-Commerce in the Context of Declining State Sales Tax Bases," part 3, by Donald Bruce and William F. Fox, *National Tax Journal*, vol. 53, no. 4 (December 2000), pp. 1373–88.
3. The predictions cover the last quarter of 2001 and all of 2002, a period that roughly corresponds to the first five quarters of the 2002–03 biennium. An exact correspondence is impossible because the Texas fiscal year starts in the middle of a calendar quarter and the analysis is based on quarterly data. Also, for purposes of estimation, sales tax receipts are lagged one month so that they are matched to the period in which the sale takes place rather than the period in which the state receives the revenue.